Washington Moves to Muzzle Wall Street

by Mike Larson 06-19-09

This was the week that Washington decided to muzzle Wall Street. Specifically, the Obama administration revealed a sweeping series of new proposed regulations and reforms — all designed to prevent the next great financial catastrophe.

The plan is multi-faceted and complex. Among other things, it aims to increase the Fed's power, regulate the derivatives and securitization markets more effectively, protect consumers from the potential harm of complex financial products, and more. It's been a long time in the making, with input from key policymakers, consumer groups, academics, and others.

Will these reforms work? Will they hamper innovation? Will they have unintended consequences, like so many of the government's other programs?

I know it might be somewhat unsatisfying, but the answer is: We simply don't know yet. We've seen all kinds of regulations passed and implemented over the years. We've created all kinds of new government agencies.

But because of industry opposition — and a lack of backbone and foresight among regulators — they've frequently failed to prevent future crises. The only way these new regulatory schemes will work is if policymakers actually USE the tools they're going to be given.

With his proposed Financial Regulatory Reform Plan, Obama hopes to prevent the next great financial catastrophe.

So what are those tools? What's coming down the pike? How will it impact you? Let's talk about that now …

The Five-Point Regulatory Plan

The government's latest regulatory plan is certainly ambitious. You can read the whole 89-page blueprint online here if you're so inclined.

The "money quotes" justifying why the Obama administration is doing what it's doing can be found in the following passage:

"While the crisis had many causes, it is clear now that the government could have done more to prevent many of these problems from growing out of control and threatening the stability of our financial system. Gaps and weaknesses in the supervision and regulation of financial firms presented challenges to our government's ability to monitor, prevent, or address risks as they built up in the system …

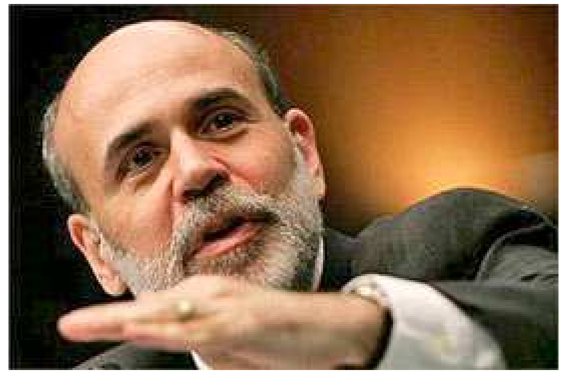
"We must build a new foundation for financial regulation and supervision that is simpler and more effectively enforced, that protects consumers and investors, that rewards innovation and that is able to adapt and evolve with changes in the financial market."

So if that's the "why" behind the plan, "how" will it work? Well, the proposed reforms are broken down into five major areas:

Plan Component #1:
Increase the Federal Reserve's power. The Fed will be allowed to rein in the biggest financial companies, even those that don't own banking subsidiaries (think insurance companies here). The administration also wants to eliminate the thrift charter used by institutions like Washington Mutual and allow the Fed to put additional restrictions on systemically important institutions, such as requiring them to hold more capital against possible losses.

Plan Component #2:
Police the securitization and derivatives markets. Securitization is the process by which underlying loans (mortgages, auto loans, credit cards) are turned into fixed-income securities owned by investors. As I explained in my July 2007 white paper, the securitization market ran amok in the early-to-mid-2000s.

Now, the government wants to increase market transparency and improve the effectiveness of the credit ratings agencies, which rate mortgage-backed and asset-backed securities. It also wants to force originators of loans packaged into securities to hold some of the credit risk, rather than handing it all off to someone else.



The regulatory overhaul of finance rules would give the Fed wide-spread power over financial institutions, including insurance companies.

Finally, it would change current compensation practices so that brokers and loan originators would earn their income over time, depending on the performance of the loans they make, rather than all up front based purely on loan volume. These measures are designed to increase the financial incentive for brokers, lenders, and loan packagers to actually write and bundle *good* loans, rather than just *more* loans.

As for derivatives, new record-keeping and reporting requirements would apply to contracts traded over the counter rather than in traditional, transparent markets. Other trading activity would be forcibly moved to regulated exchanges.

Plan Component #3:
Strengthen consumer protection. The government wants to establish a "Consumer Financial Protection Agency," whose mandate will be to protect consumers from the potential harm of complex financial products, from mortgages to credit cards.

It will help streamline disclosures so that consumers get simpler and more accurate information about potential risks. It may also be authorized to force banks to offer so-called "plain vanilla" loans, like 30-year fixed mortgages, in addition to more complicated products. The Federal Trade Commission and Securities and Exchange Commission would get additional authority to police financial products and markets, too.

Plan Component #4:
Establish "wind down" authority. Seizing and winding down large financial firms is a messy process. While the FDIC can take over smaller banks and sell them off in whole or in pieces, the government has maintained it can't effectively do the same thing for multi-dimensional, global, interconnected firms (think AIG and Citigroup).

The administration wants to change that. It would like to establish a "resolution regime" that would work like the FDIC process, but apply to these larger, more complex institutions.

Plan Component #5:
Increase international coordination. Lastly, the administration wants to establish a process whereby U.S. and foreign regulators coordinate more closely with each other in the regulation of multi-national firms. One aim is to eliminate jurisdiction-shopping — where a company might elect to move from country A to country B to benefit from country B's lighter regulatory burden.

So Will These Plans Work?

Again, that's the biggest question. And the answer depends on whom you ask. The Securities Industry and Financial Markets Association, or SIFMA, is the trade group for Wall Street securities firms, large banks and asset managers. It released what you might call a qualified endorsement of the administration's plan, saying:

"The financial turmoil of the last year revealed deep and serious flaws in our regulatory system. The financial services industry believes it is critical to our nation's economy that we work with policymakers in Washington to enact comprehensive reform this year to improve the accountability, transparency, investor protection and oversight of financial markets. With their proposals today, the Administration has moved this critical debate from broad discussion to specific action — this is an important step forward."

A spokesman for the Cato Institute (a Washington-based public policy research foundation), Gene Healy, was much less enthusiastic, though. He told a reporter that "It does begin to look like you are getting into a situation where there is no area of American life that isn't going to have an executive officer bureaucrat dedicated to it."

Some in Congress, including John Boehner, aren't convinced that more regulation is the answer.

House Republican Leader John Boehner weighed in with his own critique on *Good Morning America*. He said, "If you look deeply … we'll have the federal government deciding what interest ought to be charged on credit cards, having the government decide what kinds of financial products are available … it's just going to be too big of a foot on an industry that already is having financial problems."

Me? I'm hopeful we'll see meaningful action this year. More importantly, I'm hopeful that policymakers who are *empowered* to take new actions to police the markets and protect consumers actually *exercise* them. That's the key to making any of this stuff work.

It's unclear exactly when these provisions will start to impact the disclosures you get when you take out a mortgage, or when you'll be able to protest to the new consumer protection agency should you get shafted on a financial transaction.

Many of the proposals will require Congressional action. Additional tweaks, and maybe even wholesale changes, are likely as the House and Senate consider the administration's plan over the coming months. But you definitely want to keep an eye on Washington here, because the way we borrow, spend, and invest will be profoundly impacted in the long run.

Until next time,

Mike

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